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FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of

Implementation of Sections of
the Cable Television Consumer
Protection and Competition Act
of 1992

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MM Docket No. 93-215

REPLY COMMENTS OF GTE

GTE Service Corporation and
its affiliated domestic
telephone operating companies

Ward W. Wueste, Jr., HQE03J43
Marceil Morrell, HQE03J35
GTE Service Corporation
P.O. Box 152092
Irving, TX 75015-2092
(214) 718-6314

James R. Hobson
Jeffrey O. Moreno
Donelan, Cleary, Wood & Maser, P.C.
1275 K Street, N.W., Suite 850
Washington, DC 20005-4078
(202) 371-9500

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Their Attorneys

TABLE OF CONTENTS

	<u>PAGE</u>
SUMMARY	iii
I. CABLE OPERATORS ARGUE FOR PLANS THAT WOULD EFFECTIVELY REMOVE NON-COMPETITIVE SYSTEMS FROM REGULATION UNDER THE BENCHMARKS/PRICE CAPS METHODOLOGY	1
II. PROPERLY DESIGNED BENCHMARKS ARE CRITICAL TO A SUCCESSFUL REGULATORY SCHEME	4
III. THE PRICE CAP MUST ENCOMPASS AN EFFECTIVE INCENTIVE FOR CABLE OPERATORS TO IMPROVE EFFICIENCIES	7
A. The GTE Competitive Price Cap Model Provides an Effective and Simple Means of Ensuring Efficient Behavior.....	7
B. Challenges to the Inclusion of a Productivity Factor are Invalid or Addressed by the GTE Competitive Price Cap Model.....	10
C. Absent Adoption of the GTE Model, the Cable Productivity Incentive Should be Set Equal to the LEC Productivity Incentive	17
IV. REPLY TO COMMENTS ON COST OF SERVICE REQUIREMENTS.....	19
A. Proposed Alternatives to Cost of Service as the Backstop Should be Rejected	19
B. Other Issues	21
1. Adoption of a Uniform System Of Accounts (USOA) is a more solid foundation for cost-of-service showings than Generally Accepted Accounting Principles (GAAP)	21
2. The Commission should adhere to its preference for valuing ratebase at original cost.....	23
3. Because the threat of cable rate regulation did not materialize suddenly in 1992, consumers should not be expected to absorb acquisition expenses imprudently founded upon continued deregulation	27
4. Adoption of a price cap depreciation prescription process should be pursued as opposed to the process instituted under rate of return regulation	29
5. The Commission should affirm its tentative decision to adopt a unitary rate of return and use the S&P 400 and the LECs as the surrogates to determine the cable industry rate of return	30

a.	Adoption of a unitary rate of return for the cable operators is appropriate	30
b.	Use of the S&P 400 and the LECs as surrogates to determine the rate of return is proper	32
6.	Cost allocation should generally follow the common carrier rules and should be maintained at the MSO level	32
7.	Affiliate transaction rules specified in Part 64 of the common carrier rules should be followed with two exceptions.....	33
8.	Mark-up of programming expenses has not been justified on this record.....	34
V.	CONCLUSION	36

SUMMARY

The Commission has affirmed its intent to use a benchmark formula based on "competitive differential" of competitive system rates and noncompetitive rates, followed by price caps. The issue of whether there should be such regulation is, in GTE's opinion, now determined. GTE proposes a further review of the analysis that created the present benchmark rates to true those rates up. This is essential because there is a basic tradeoff between the quality and completeness of the benchmark model and the necessity to rely on Cost-of-Service as a backstop. GTE has shown that the former will obviate the necessity for the latter.

Although several commenters have proposals which merit further study, such as inclusion of additional variables, their processes are flawed. GTE has demonstrated that the Commission must rerun the entire benchmark analysis if it determines that such variables as addressability are appropriate. The cable operators should not be allowed to choose among adjustments if the regulatory result is to be unbiased.

GTE has proposed that the Commission adopt a Competitive Price Cap Model which relies on the change in price of competitive cable systems rather than use the GNPPPI as originally announced. Adoption of such a model will remove virtually all of the alleged deficiencies in the present model. Simply stated, GTE proposes that the Commission cap the price changes of regulated cable systems to the annual change in price of competitive cable systems. Such a model fulfills the two important regulatory constructs of compensation and efficiency by providing a valid external target for input price change and productivity. No one can argue that a competitive cable system lacks incentive to achieve maximum productivity gains.

Such modifications to the Commission's price cap model as use of a single factor measure of productivity must be rejected. Similarly, where cable operators argue that the cable industry cannot achieve any productivity gains in excess of the general economy, commenters are ignoring the high technology of the industry and the

experience of LECs with the productivity offered by fiber optics and advanced electronics.

Nor will the incentive for quality improvement or investment be inhibited by use of either the GTE Competitive Price Cap Model or the GNPPI-x model. In fact, if the Commission were to adopt the GNPPI formula, it is appropriate to use the LEC productivity offset as the x factor. No other industry has been offered as having attributes that so closely paralleled the cable industry as the LECs. Both have extensive distribution plants, have benefited from technological advances in transmission and computer technologies, require similar types of skilled labor, and have investment that is "lumpy."

The Commission should adopt an accounting system similar to the USOA, provide a method of depreciation similar to the price cap carrier option to be applied to an original cost rate base and utilize a unitary rate of return established using the S&P 400 and the LECs as surrogates. This will provide a Cost-of Service methodology which will serve as a backstop.

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REPLY COMMENTS OF GTE

GTE Service Corporation and its affiliated domestic telephone companies ("GTE") reply to a number of comments¹ filed in reference to the Notice of Proposed Rulemaking ("NPRM" or "Notice"), FCC 93-353 (released July 16, 1993) and urge the Commission to adopt a benchmark/price caps/cost of service scheme as proposed by GTE with the additional suggestions contained herein.

I. CABLE OPERATORS ARGUE FOR PLANS THAT WOULD EFFECTIVELY REMOVE NON-COMPETITIVE SYSTEMS FROM REGULATION UNDER THE BENCHMARKS/PRICE CAPS METHODOLOGY.

Following the filing of comments in this docket on August 25, 1993, by approximately thirty-eight commenters, the Commission released its *Rate Regulation*

¹ Arthur Andersen & Co. (Arthur Andersen), Bell Atlantic, et al. (Bell Atlantic), BellSouth Telecommunications, Inc. (BellSouth), Cablevision Industries Corporation, et. al. (Joint Parties), Cablevision Systems Corporation (Cablevision), Comcast Cable Communications, Inc. (Comcast), Community Antenna Television Association, Inc. (CATA), Continental Cablevision, Inc. (Continental), Discovery Communications, Inc. (Discovery), National Cable Television Association (NCTA), Tele-Communications, Inc. (TCI), Tele-Media Corporation (Tele-Media), Time Warner Entertainment Company, L.P. (Time Warner), Adelphia Communications Corporation, et al. (Medium Sized Operators Group).

*Reconsideration Order*² in which the Commission affirmed its intent to use a benchmark formula based on the "competitive differential" between competitive system rates and noncompetitive or monopoly system rates.³ The Commission also affirmed its intent to use "a price cap mechanism once initial rates were determined"⁴ and noted, however, that the benchmark formula is still subject to review.⁵ Since the *NPRM*⁶ indicated the Commission's intent to dispose of common issues in both MM Docket No. 92-266 and this docket, GTE will respond as necessary to issues to be decided in connection with cable ratemaking.

One year after the passage of the 1992 Cable Act,⁷ some cable operators continue to exert efforts to avoid any rate regulation.⁸ Arguments that the proposed regulations are too complex and too burdensome, and which propose simplifications appear to be poorly disguised attempts to avoid regulation. The statutory requirements are clear: rates of cable systems not subject to competition are subject to regulation. Congress made its policy decision in adopting regulation and directed the Commission

² Implementation of the Cable Television Consumer Protection and Competition Act of 1992 - Rate Regulation, MM Docket No. 92-266, First Order on Reconsideration, Second Report and Order, and Third Notice of Proposed Rulemaking, Released August 27, 1993 ("*Rate Regulation Reconsideration Order*").

³ *Id.* at paragraph 4.

⁴ *Id.* at paragraph 87.

⁵ *Id.* at paragraph 4, n.7.

⁶ Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, Notice of Proposed Rulemaking, MM Docket No. 93-215 (released July 24, 1993) ("*NPRM*") at paragraph 7, n.10.

⁷ Cable Television Consumer Protection and Competition Act, Pub. L. No. 102-385, Section 2(b)(4), 106 Stat. 1460 (1992) ("*1992 Cable Act*").

⁸ Mark Robichaux, "Cable Firms Push to Short-Circuit '92 Law," THE WALL STREET JOURNAL, Friday, August 27, 1993, at B1.

to look to the competitive market in devising its regulatory scheme.⁹ Other commenters, including cable operators, endorse the competitive behavioral standard.¹⁰

The Commission's *Rate Regulation Reconsideration Order* reasserts the Commission's determination to rely on the competitive benchmark to establish an initial level of reasonable rates that will then be controlled going forward by a price cap index.¹¹ Acknowledging that the benchmark is not static, the Commission has indicated its intention to revisit the formula.¹² As GTE's Comments in this NPRM demonstrated, the determination of an appropriate benchmark is essential to the maintenance of the benchmark/price caps scheme, and will make cost of service proceedings a rarity and an exception.¹³ GTE supports the Commission's efforts to review the benchmarks.

Commenters have offered widely varying positions on the issues of the appropriate productivity adjustment for the price cap and to determine the specific components of the cost of service backstop. The Commission must balance the proposals in a manner that addresses the rights of both customers and stockholders and that also comports with Congressional directives. The model proposed by GTE in its Comments at page 19 would allow regulated cable prices to grow at the same rate as competitive system prices, would clearly achieve the desired competitive-like

⁹ 1992 Cable Act, Section 3(a), sections 623(b)(1) and (c)(2)(B).

¹⁰ TCI at 7. Tele-Media at 4-5.

¹¹ *Rate Regulation Reconsideration Order* at paragraph 12.

¹² *Id.* at paragraph 4, n.7.

¹³ GTE at 14. GTE offered the Statement of Dr. Mark Schankerman, a tenured faculty member in the Department of Economics at the London School of Economics and Political Science, as an attachment. Dr. Schankerman's areas of expertise include the economics of technological change, productivity, and industrial organization. Dr. Schankerman noted that there is a basic tradeoff in designing this regulatory framework of benchmarks and ongoing price caps between the quality and completeness of the benchmark model on the one hand, and the reliance on cost-of-service appeals on the other.

outcome, and would also avoid the problems inherent in the alternatives. The GTE Competitive Price Caps Model eliminates the need for a separate productivity offset, provides incentives for efficient behavior as well as quality improvements, and recognizes unusually high cost factors unique to cable. Because the GTE Competitive Price Caps Model requires minimal data collection, it can be quickly implemented, an important practical consideration, as well as a statutory requirement.¹⁴

II. PROPERLY DESIGNED BENCHMARKS ARE CRITICAL TO A SUCCESSFUL REGULATORY SCHEME.

Several commenters including Time Warner stress the need to improve the benchmarks directly or through "high cost" showings because several cost causation factors were not included in the preliminary analysis.¹⁵ GTE concurs in this assessment but cautions the Commission to avoid an endless cycle of restating the benchmarks. Use of an accurate benchmark to set the rates that will be subjected to the price cap coupled with a well designed price cap will minimize the need to rely on the cost of service backstop.¹⁶ Continual resetting of the benchmarks will compromise the fundamental premise of efficiency inherent in the benchmark/price caps model because the rate constraint will be reset on internally generated behavior.¹⁷ That is, there is the potential to manipulate the results and the data collected will reflect both efficient and

¹⁴ 1992 Cable Act, sec. 3a, sections 623(b)(2) and (c)(1).

¹⁵ Time-Warner at 16, Lewis J. Perl, Paul S. Brandon, John H. Landon, Anna P. Della Valle, "A Proposal for Backstop Regulation for Cable Television Prices," August 24, 1993 at 28 (the "NERA Paper"). The NERA Paper lists nine categories of potential cost causation factors gleaned from petitions for reconsideration in MM Docket No. 92-266.

¹⁶ See Thomas J. Fox, Counsel to New York State Assembly Committee on Oversight, Analysis and Investigation, at 12. GTE at 15.

¹⁷ GTE Attachment at 6. A benchmark which is not set carefully may result in "allocative distortion."

inefficient behavior. GTE urges the Commission to make a one time modification based on data collected for the period prior to the imposition of regulation. Having adopted the benchmark/price cap model, the Commission should confine use of cost of service as a means of determining rates to "extraordinary circumstances" as advocated.¹⁸ Dr. Schankerman explained the criticality of limiting cost of service relief to avoid compromising the efficiency principle of price cap regulation.¹⁹

Two commenters offer studies that suggest adjustments the Commission should make to its benchmark analysis. One, Continental, offers the basis, but not the correct technique, for a benchmark adjustment that may have merit, a technology variable for addressability. Continental offers the study of Economics & Technology, Inc., to show that there may be a statistical relationship between price as it reflects cost and whether the system has been upgraded with addressable facilities.²⁰ Continental offers this single factor to be added to the existing benchmark prices claiming that the Commission would not need to rerun its original regression analysis.²¹ However, the Commission must be cautious about accepting this on its face. While there may be a

¹⁸ Arlington County, VA at 2, Michigan Ad Hoc Committee For Fair Cable Rates at 2, National Association of Telecommunications Officers and Advisors, et al. at 6, City of Austin at 4-5.

¹⁹ GTE Attachment at 4, 5.

²⁰ Continental Exhibit D, Appendix 2, David J. Roddy, "The Effects of Adding Addressability to the FCC's Cable TV Benchmark Regression Model" August 19, 1993, at 3 (the "ETI Report").

²¹ The ETI Report explains that the technique used of estimating on the residuals is constrained so "that the parameters of the Commission's model . . . cannot change." ETI Report, Appendix 2 at 4. This means that the estimated coefficients in the Commission's model are not allowed to reflect any interaction between the independent variables. This is not a reasonable assumption. At a minimum before this addressability adjustment or any other new adjustment associated with an additional explanatory variable is adopted, the entire benchmark regression should be rerun. In this way the estimated coefficients would reflect interactions.

relationship, the size of the adjustment should be determined through multivariate analysis, a method where all of the proposed explanatory variables are included in the equation simultaneously. This is necessary because the effect of the one variable, addressability, on output price is most likely not simply additive to the effects of the other explanatory variables in the equation. This means that the coefficients estimating the relationships will change. In fact, some of those coefficients that were significant in the original analysis may no longer be significant. If not, those variables should be removed from the analysis.²²

In contrast, the NERA Report illustrates one proper multivariate technique for assessing the impact of additional explanatory variables, inclusive of addressability, in the Commission's regression analysis.²³ However, the NERA Report improperly proposes that once such enhancements to the Commission's regression analysis are demonstrated and have withstood challenge, they apply only to those systems which brought the "appeal" to the Commission.²⁴ This selective application is self serving and must be rejected. Adjustments made to the benchmark must be made on the basis

²² In addition to the inappropriateness of the method used to estimate the effect of addressability on price, the method used by ETI to translate the coefficient of the estimated relationship between addressability and the residuals is patently misleading. ETI applies the adjustment at the sample mean of the other benchmark determinants, i.e., the sample means of the independent variables in the Commission's regression equation. (ETI Report, Appendix 2 at pages 5-6.) This implies that there is no systematic difference in the cost of addressability and number of subscribers, number of channels and number of satellite channels. It would seem reasonable to expect that the cost per channel of "addressability" decreases with more customers and more channels. Under the ETI calculation large systems with large numbers of channels would be afforded the same price per channel adjustment as a small system with few channels so long as they had the same percentage of system addressability. In other words, the ETI Report's proposed adjustment is likely biased in favor of the larger systems.

²³ NERA Report at 32-33.

²⁴ NERA Report at 29.

that they are cost causative, and, for the benchmark to mirror competition, must be applied to all cable systems. Cable operators cannot be permitted to chose among adjustments if the regulatory result is to be unbiased. As GTE has pointed out above, the Commission must be careful to undertake a one-time only refinement of the benchmarks in order to ensure efficiency incentives of the price cap are not lost.

GTE urges the Commission to make a one-time enhancement to its benchmark to take into account more cost causative factors, but do so in a legitimate fashion, i.e., by recasting the regression analysis with all proposed explanatory variables, removing those variables that do not contribute significantly to the explanatory power of the analysis, and applying the results to all regulated cable systems.

III. THE PRICE CAP MUST ENCOMPASS AN EFFECTIVE INCENTIVE FOR CABLE OPERATORS TO IMPROVE EFFICIENCIES.

A. The GTE Competitive Price Cap Model Provides an Effective and Simple Means of Ensuring Efficient Behavior.

The continuing success of the price cap regulatory scheme in terms of keeping prices reasonable both for consumers and stockholders depends not only on the selection of an appropriate input price change target but the selection of the appropriate productivity offset target as well. Selection of the correct targets or external yardsticks for input price change and for productivity growth are fundamental to the price cap regulatory model fulfilling the compensation and efficiency principles.²⁵

If the Commission goes forward with a productivity target, i.e., an x-factor, of zero, it is essentially saying that, in the future, it expects the cable systems to perform no better than the economy at large. To the degree that the Commission wants to encourage greater efficiency gains than in the past, the use of a zero x-factor means that the Commission believes that historical cable productivity is less than that of the

²⁵ GTE at 14.

economy at large.²⁶ In other words, the Commission would be saying that the average firm outperforms the cable industry. This would ignore the existence of cable's significant scale economies and its access to advanced electronics and fiber optic technology. Clearly, if the ongoing regulatory scheme is to provide a realistic incentive for cable operators to improve efficiency, the Commission must incorporate an efficiency offset into the price cap constraint.

Overall efficiency is measured in terms of Total Factor Productivity (TFP).²⁷ The parties addressing the productivity offset agree that there is no published study of cable industry TFP and further, seem to agree that the process to develop one is lengthy and contentious.²⁸ The arguments presented by commenters over what that process might reveal abound. The speculations range from productivity gains far worse than the general economy to much better. Further, a host of concerns are voiced that even if a substantiated estimate of historical TFP growth was available, it would need to be adjusted. By the time a TFP growth offset could be calculated, critiqued and adopted, several years would probably be gone. The need for an appropriate adjustment is immediate if the price cap scheme is to meet the statutory mandate to achieve through regulation the outcome of the competitive market to control price and improve quality.²⁹

The GTE Competitive Price Cap Model is an alternative price cap formula based upon the behavior of competitive cable systems that provides a strong incentive to

²⁶ Several cable operators claim that historical TFP growth is at or below that of the economy but offer no compelling evidence or even sound economic reasoning. See e.g., Cable TV of Georgia, et al. at 41; Joint Parties at 60.

²⁷ See e.g., Continental at 89.

²⁸ Continental at 88-90. Medium Sized Operators Group at 14. NCTA at 33 ("[T]here is no way to measure increases in cable productivity.") Discovery at 6-7. Joint Parties at 60. BellSouth at 34. Thomas J. Fox at 70, TCI at 70.

²⁹ 1992 Cable Act, sec. 3a, sections 623(b)(2) and (c)(1).

improve productivity and addresses the problems commenters raised with the use of a specific TFP growth offset. The unusual existence of both competitive and monopoly cable systems offering nearly identical services allows the use of a straightforward, theoretically sound price cap mechanism based directly on the change in prices of competitive cable systems.³⁰

Very simply, GTE proposes that the Commission cap the price changes of regulated cable systems to the annual change in price of competitive cable systems.³¹ Dr. Schankerman demonstrates that this competitive cap fulfills the two important regulatory constructs of compensation and efficiency, and discusses how it provides a valid external target for input price change and productivity.³² As a group, competitive cable systems must provide a better yardstick for price performance than does price inflation for the economy as a whole. No one can argue that a competitive cable system lacks incentive to achieve maximum productivity gains. Additionally, the GTE Competitive Price Cap Model meets TCI's concern over "Congress' directive to keep rate regulation as simple as possible. . . ."³³

The Competitive Price Cap Model proposed by GTE is superior to the provisionally adopted GNPPI-x specification not only because, as will be detailed, it resolves all of the issues brought up by commenters regarding the appropriate productivity target, but also because it provides a better means of establishing the external target or yardstick for input price changes.³⁴

³⁰ GTE at 18-19.

³¹ The mathematical expression is $dp_m = dp_c$, where dp denotes change in price and the subscripts denote monopoly and competitive firms respectively.

³² GTE Attachment at 12.

³³ TCI at 70.

³⁴ GTE Attachment at 8-14.

B. Challenges to the Inclusion of a Productivity Factor are Invalid or Addressed by the GTE Competitive Price Cap Model.

Several parties argue against a productivity offset on the grounds that it is already in part accounted for in the benchmarks. They claim productivity is included in benchmarks set on a per channel basis.³⁵ As GTE explained in its Comments, the per channel benchmarks reflect only a point on the unit cost curve and do not account for either changes in productivity due to movement along the curve (scale economies) or shifts of the curve itself (technological efficiencies).³⁶ Thus, it is the change in TFP that must be captured and embodied in the price cap model, while the benchmark reflects only the level of productivity at a point in time. The GTE Competitive Price Cap Model, as it is updated with each year's competitive cable price change, will automatically reflect the growth in TFP of those firms measured on a per channel basis.

Cable TV of Georgia et al. argues that no offset is needed because historical cable TFP growth is below that of the economy at large.³⁷ Other commenters simply assert that the offset should be zero.³⁸ However, none offers any empirical evidence or sound economic reasoning to support such claims.

Continental attempts to provide empirical evidence to dismiss the need for a TFP adjustment to the Commission's price cap formula on the basis of labor productivity. Continental tries to demonstrate that "the cable industry's approximate 'labor productivity' trend . . . is essentially zero . . . [and argues] . . . even if the Commission

³⁵ Joint Parties at 60. Discovery at 6.

³⁶ GTE Attachment at 19.

³⁷ Cable TV of Georgia et al. at 41.

³⁸ Joint Parties at 61; Cablevision at 41.

were to adopt the productivity offset concept, the available data indicate that the correct value would be zero."³⁹

Continental's claim should be rejected first because it is a single factor measure and by itself implies nothing about the size of the correct measure, TFP. Labor is but one component of TFP. All components must be considered simultaneously. Continental in its own comments recognized that TFP is the correct measure.⁴⁰ As ETI says, "The correct approach to productivity measurement in the cable industry requires investigation of the total factor productivity concept."⁴¹ Second, the method used to calculate the claimed labor productivity is invalid. ETI compares growth in the number of cable subscribers (their measure of output) to the growth in the number of cable employees for the period 1981 to 1991. They argue that since the rates of growth are the same there has been no labor productivity growth.⁴² This is fallacious reasoning. ETI even characterizes it as a "poor substitute."⁴³ The output of the cable industry should not be measured solely in terms of subscribers but also in terms of channels. It is well known that during this period the number of channels offered including premium and pay-per-view channels grew several fold, in many cases from 12 channel systems to systems offering over 50 channels. The Commission recognized this output component in structuring its cable benchmark and price cap scheme.⁴⁴ Even ETI

³⁹ Continental, Appendix 3 at 2.

⁴⁰ Continental at 89.

⁴¹ Continental, Appendix 3 at 4.

⁴² Continental, Appendix 3 at 6.

⁴³ *Id.*

⁴⁴ Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992 - Rate Regulation, MM Docket No. 92-266, Report and Order and Further Notice of Proposed Rulemaking, paragraph 238 (released May 3, 1993) ("Rate Regulation Order").

recognizes that "productivity is directly related to the cost per channel" (emphasis added).⁴⁵

Again, the use of GTE's Competitive Price Cap Model removes the issue of the size of cable TFP in relation to the economy-wide TFP by providing a direct linkage to productivity gains in the competitive cable market.

NCTA and others argue that the productivity offset as it was developed and applied in the context of telephone regulation is inappropriate because telephone companies were moving from cost of service regulation to price caps.⁴⁶ These parties argue that a productivity offset was necessary to wring out Averch-Johnson effects in the telephone industry. They argue that the transition here "where cable operators are moving from a free market to a regulated environment"⁴⁷ is different, without inherent inefficiencies. A key factor has been overlooked. It is true that the cable industry has been operating without regulation. However, the so called "free market" is not a competitive market. While firms in a competitive market must be as efficient as possible in order to survive, these cable operators, as unregulated monopolists, were not driven to the most efficient solutions.

This issue can be avoided by use of the Competitive Price Cap Model because the productivity target for the regulated cable systems is what is achievable for cable systems under competition. Further, to the degree that there are any embedded inefficiencies in the systems now subject to regulation, they will be driven out under the

⁴⁵ Continental, Appendix 3 at 1, n.2.

⁴⁶ NCTA at 31; TCI at 69; Time-Warner at 47; Medium-Sized Operators Group at 14. Thomas J. Fox at 68.

⁴⁷ NCTA at 32. NCTA worries that "[a]pplying a productivity offset to cable television under these circumstances will reduce rates below presumptively competitive levels." NCTA would ignore that a price cap with an x-factor of zero is just as likely to produce rates that are above presumptively competitive levels.

Competitive Price Cap Model. This formula manifests the price cap's theoretical effect of "motivating the regulated company to perform like a competitive firm."⁴⁸

Cablevision similarly argues that the character of its business compared to the telephone business is different and removes the need for a productivity incentive. Cablevision would have the Commission reject the need for a productivity offset by claiming that since "cable's basic infrastructure is still being built, and penetration remains at low or moderate levels . . . operators continue to have an incentive to keep overall costs at a low level and to maximize efficiency."⁴⁹ It is not at all clear that such incentives exist even for immature, expanding firms unless prices are constrained either by regulation or by competition. If the Commission structures the price cap in a way that allows these monopoly firms to operate under an ineffective price constraint because it does not include a sufficiently high TFP target, there is no strong incentive to seek efficiency improvements. In other words, if the price cap allows a price increase that is greater than the growth in input prices less productivity gains, the monopoly cable operator will not behave in the most efficient manner.⁵⁰

Time-Warner, in contrast to Cablevision Systems, believes the industry is mature and that "[p]roductivity increases that have been generated as a result of economies of fill and economies of scale cannot be expected to continue at the same level in the future."⁵¹ Other operators believe that historical TFP cannot be used because there is

⁴⁸ NCTA at 31.

⁴⁹ Cablevision at 41.

⁵⁰ GTE Attachment at 7, n.11.

⁵¹ Time-Warner at 44.

no reason to expect such increases in the future.⁵² Claims that most economies have already been captured conflict with the market statistics that while cable facilities pass over 90 percent of households, only about 60 percent subscribe. This would mean that the marginal cost of serving another subscriber is near zero until such time that additional facilities are required. Even when new investment is required, it does not follow that there are zero or below average efficiency gains. Often capital investments embody technological change which will improve TFP. Disagreement over the size of expected TFP growth, whether for a mature or immature industry, can be avoided by using the productivity achieved each year by the competitive cable systems and demonstrated in their price change.

Continental argues that it is inappropriate to include a productivity offset because of the variation in productivity across systems.⁵³ GTE urges the Commission to consider carefully arguments against an offset based on unsupported claims of wide variance. First, the measure under evaluation is target productivity. While individual system behavior may vary, the object is to establish an external yardstick as the target. Use of individual firm productivity growth in the price cap formula would relegate it to nothing more than cost plus regulation.⁵⁴ Second, no actual evidence is presented to demonstrate wide variance. Third, the target is based on the rate of change in productivity not actual productivity level. Thus, while all firms are given the same percentage change in TFP as a target, they do not all have to achieve the same level of efficiency. This works to mitigate the variation.

⁵² Joint Parties at 61. NCTA at 33. NCTA even makes a convoluted argument that the application of cost of service regulation will cause inefficient behavior requiring a lower than historical productivity offset. NCTA seems to have conveniently ignored the fact that the productivity offset applies to those firms regulated by price caps and further, that Cost-of-Service sets rates based on actual productivity.

⁵³ Continental, Appendix 3 at 3-4 (productivity varies by size and density).

⁵⁴ GTE Attachment at 3.

This will not be an issue with the use of the price cap based on competitive system price change because it captures growth in productivity attained by a group of cable firms. The Commission has already used this group in its benchmark to set initial rates that are reasonable. Further, the Commission reaffirmed "the Rate Order properly placed primary weight on the rates of systems subject to effective competition in fashioning the benchmark approach."⁵⁵ The use of their performance is equally appropriate here.

Several parties claim that the inclusion of an x-factor will harm incentives to improve quality in general and to update or expand physical facilities.⁵⁶ It cannot be argued conclusively that a TFP offset will inhibit new investment. Much of the new investment planned for fiber and addressability will actually increase productivity as well as provide improved quality. Thus, a productivity target can encourage firms to seek efficiency improving investment. In adopting the LEC price caps, the Commission found "that price cap regulation will serve . . . to encourage the LECs to maintain and expand the excellence of the network. . . . By creating incentives for carriers to become more productive, incentive regulation generates powerful motives to innovate."⁵⁷ GTE's Competitive Price Cap Model would specifically rectify the failure of "[s]imple adjustments for inflation based on the GNP-PI index applied to the benchmark tables [to] account for the quality-based and cost-based increases in service rates for the 'competitive' systems. . . ."⁵⁸

⁵⁵ Rate Regulation Reconsideration Order at paragraph 12.

⁵⁶ NCTA at 32; Time-Warner at 44; Joint Parties at 61.

⁵⁷ Policy and Rules Concerning Rates for Dominant Carriers, Order on Reconsideration, 6 FCC Rcd 2637, 2718 (1991).

⁵⁸ NCTA Appendix C at 2.

Discovery argues that any productivity offset should not be applied to programming because they are considered external costs.⁵⁹ BellSouth argues that the selection of the appropriate productivity offset must take into account the degree to which certain costs are treated exogenously.⁶⁰ In theory, BellSouth is correct that the size of the productivity offset should be adjusted to account for factors treated exogenously in the price cap. In practice it will be difficult to assess how much to adjust for because it will require not only the measurement of TFP, but also the measurement of productivity associated with the externally treated factors, e.g., programming. In general, the greater the proportion of costs treated externally the more important the adjustment to the x-factor.

Rather than making a correction to the target for external costs or to the cap for new investments, GTE encourages the Commission to instead use the Competitive Price Cap Model which recognizes price changes inclusive of programming cost changes. The Commission wants to both induce efficiency and improve quality. These dual objectives would usually require two separate instruments. The Competitive Price Cap Model will serve to meet both because it incorporates the productivity and quality target implicit in the competitive price change. Therefore, it stimulates regulated cable systems to seek additional and improved programming and technological and facilities improvements to the same degree as in the competitive cable market. Competitive systems compete on both price and quality of offerings.

Cable operators acknowledge that TFP growth, if known or predictable, is a legitimate factor in the price cap mechanism, but then argue that the "correct" offset cannot be identified. The cable operators attack possible TFP measures, yet, none of the cable operators suggests an alternative means to encourage more efficient

⁵⁹ Discovery at 6. See also Joint Parties at 60, n.64.

⁶⁰ BellSouth at 34.

behavior than that of the economy as a whole (implicit in the use of GNPPI). The competitive price cap formula endorsed by GTE resolves entirely the issues around incorporating the "correct" x-factor because it inherently reflects the right productivity yardstick, the ability of competitive cable operators to improve TFP.

C. Absent Adoption of the GTE Model, the Cable Productivity Incentive Should be Set Equal to the LEC Productivity Incentive.

If the Commission does not adopt the GTE Competitive Price Cap Model which altogether avoids separate measurement of productivity, but instead uses the GNPPI specification, GTE believes it is critical that the Commission use the LEC offset, currently 3.3 percent. The commenters tend to line up on two sides: One side consists of cable operators or affiliates who recognize the concept of productivity growth but claim cable TFP growth is below the average of the economy, likely to decrease in the future, or would not capture certain important characteristics. The other side is concerned over impacts on customers or competitors, believes it is obvious that cable is a high technology industry with above average TFP growth and sees the need for a productivity offset greater than zero. The debate is not about whether efficiency incentives are desirable, but rather about the size of the appropriate target. No direct estimate of the cable industry's TFP growth is available, or likely to be in any useful time frame. The next best solution (given Commission choice of a GNPPI-x type specification) is to use the TFP offset of a highly similar industry, the LECs.⁶¹ No other industry has been offered as having attributes that so closely parallel the cable industry.

The LECs and cable systems both have extensive distribution plants, have benefited from technological advances in transmission and computer technologies,

⁶¹ BellSouth at 35. Bell Atlantic et al. at 11; Consumer Federation of America at 8; Economic and Technical Consultants, Inc. at 8; Counsel to the Municipal Franchising Authorities at 31; Austin, Texas et al. at 15.

require similar types of skilled labor, and have investment that is "lumpy."⁶² Some cable operators have attempted to distinguish the cable and telephone components of the communications industry. However, their justifications taken together are contradictory. For example, NCTA argues that LECs offer a single, constant quality service while cable services are multiple and diverse.⁶³ On the other hand, Time-Warner claims that cable is a uniform single service offering and telephone is comprised of wide-ranging varying quality services.⁶⁴ There may be legitimate arguments that LECs and cable systems were once different. But, there is little doubt that LECs and cable soon will be indistinguishable. In response to the recent court decision allowing Bell Atlantic to provide cable programming, the cable industry said it would "accelerate [LEC-cable] joint ventures" and "lead the way for cable's entry into the local telephone business."⁶⁵

GTE believes it would be better to include an offset that is too high, leaving the burden with the cable operators when necessary to rely on the cost of service backstop, than to adopt one that is too low. To do otherwise would provide no effective efficiency incentive and result in unreasonable rates.

⁶² See Bell Atlantic et al., Affidavit of Robert L. Townsend for a thorough discussion of the cost characteristics of the cable industry. See Continental Appendix 3 at 5..

⁶³ NCTA at 32. NCTA conveniently ignores the increase in "dialtone" service quality that digital switching and fiber optic transmission offer the LEC customer.

⁶⁴ Time-Warner at 45.

⁶⁵ Rich Brown, "Cable Sees Positive in Telco Entry Ruling," Broadcasting and Cable, August 30, 1993, at 11.

IV. REPLY TO COMMENTS ON COST OF SERVICE REQUIREMENTS.

A. Proposed Alternatives to Cost of Service as the Backstop Should Be Rejected.

Several commenters propose that the Commission design a backstop for adjusting prices obtained from the benchmark/price cap model using more simplified means than full cost of service showings. These proposals should be dismissed because they are either unnecessary given the specification of the price cap or they do not establish a significant need showing to be used as a backstop.

One such proposal is that if a cable operator can show that one or more input factors has an above-average cost, the cable operator be allowed an adjustment to the price cap to offset the cost that is above average. This proposal has no merit. It simply allows increases for those above-average costs while there is no offset for below-average costs. It could be likened to single issue ratemaking which is not an accepted regulatory method, and illegal in many jurisdictions. As recognized by the Illinois Supreme Court:

The rule against single-issue ratemaking recognizes that the revenue formula is designed to determine the revenue requirement based on the aggregate costs and demand of the utility. Therefore, it would be improper to consider changes to components of the revenue requirement in isolation.⁶⁶

The rationale is that changes in one item of a revenue formula are often offset by corresponding changes in other components. Thus, allowing cable operators to make

⁶⁶ *Business and Professional People for the Public Interest v. Ill. Commerce Comm.*, 585 N.E.2d 1032, 1061 (Ill. 1991). See also, *State of Missouri v. PSC of Missouri*, 1993 Mo.App. LEXIS 1188 (Aug. 3, 1993); *Application of Baltimore G & E Co. for Revisions in its Electric Rates*, 118 P.U.R.4th 364 (Md. PSC 1990); *Pa. PUC v. Philadelphia Elec. Co.*, 1990 Pa. PUC LEXIS 155 (Pa. PUC May 16, 1990); *Application of GTE Southwest Inc. for a Rate Increase*, 106 P.U.R.4th 194 (PUC Tex. 1989); *Petition of U S West Communications Inc.*, 1993 Wash. UTC LEXIS 31 (Wash. UTC April 15, 1993); *Potomac Electric Power Co.*, Formal Case No. 905 Order No. 9717, DCPSC, ___ P.U.R.4th ___ (DC PSC May 31, 1991).

adjustments to the price cap to offset above-average cost factors may ignore below-average cost factors and thereby overstate the revenue requirement. Any incentive for efficiency is removed and indeed, could cause inefficiency, because it rewards poor cost controlling behavior.

There are, of course, adjustments for costs outside the control of cable operators which should be made. These costs fall into the same category as those defined as exogenous in the LEC price cap scheme. There is a key distinction that must be applied before a cost is placed in this category: such costs must not already be reflected in the price cap adjustment through the price change measure or the productivity adjustment. Offhand there should be very few exogenous factors if the GTE proposed Competitive Price Cap Model is used because it would reflect the impact of presumably the same exogenous effects on the output price of cable firms subject to competition.

CATA offers another means of allowing rates to exceed price caps, proposing that a cable operator "could opt out of the benchmark/price cap system, if it increased its subscriber penetration level by ... its penetration benchmark"⁶⁷ Under this proposal, so long as subscriber penetration meets a Commission established target under the operator's chosen rate level, the rate should be considered acceptable. CATA argues that the growth in customers indicates that the rate meets a market test of reasonableness. CATA claims that so long as the noncompetitive firm has subscribership at levels considered "competitive" the rates are reasonable. CATA would argue that the fact that customers will pay the price means the price is reasonable.

⁶⁷ CATA, Appendix, Peter K. Pitsch, "Implementation and Analysis of Cost of Service Regulation for the Cable Service Industry," August 25, 1993 at page 8.